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UDITPA – A HISTORICAL PERSPECTIVE

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Prior to 1957, the need for uniformity in state income taxation of multistate businesses was something like the weather – everybody talked about it, but nobody did anything about it. Then in that year, the Uniform Division of Income for Tax Purposes Act was born. For awhile it looked like it would be nothing more than an academic exercise. Then came the introduction in Congress of the Willis Bill in 1964, which would have imposed on the states a uniform apportionment formula (property and payroll factors) and a uniform tax base (federal taxable income). The states' response was a rush to adopt UDITPA to show that they could solve the uniformity problem without Congressional interference.

When the National Conference of Commissioners on Uniform State Laws took up the state taxation project, they appointed Professor William J. Pierce of the University of Michigan Law School to draft a model statute. Pierce's draft was submitted to the Federation of Tax Administrators for review and comment, and the FTA invited the states to a conference in Chicago in May of 1957 to discuss the draft with Pierce and George V. Powell, chairman of the

NCCUSL committee on allocation and apportionment. Only eight states sent representatives, which was evidence of their coolness toward collaboration on this subject.

I represented California at the conference, and I must say that what was accomplished there made the model act conform much more closely to the existing California practice.

When I refer herein to "the drafters" of UDITPA, I mean to include Professor Pierce, the participants in the May 1957 conference, and of course NCCUSL itself.

Allocation vs. Apportionment

In Professor Pierce's first draft, he relied on labels in distinguishing between income to be apportioned and income to be allocated to a single situs. Single situs rules were applied to income bearing the labels of dividend, interest, rent or royalty. This left only income from sales of goods and services to be apportioned by formula (and is probably the reason why the third factor of the formula was named the "sales factor" whereas the more inclusive term "receipts factor" might have been more appropriate). In California, however, there was a line of decisions holding interest, rents and royalties, under some circumstances, to be apportionable in the same manner as income from sales.

The best example was a case involving IBM at a time when the company was manufacturing patented office machines, sometimes selling them and sometimes renting them, and was also licensing others to use its patents in the manufacture of their office machines. It seemed eminently sensible to apportion the sales income, the rental income, and the royalty

income altogether by the formula method. Other cases reached the same result with respect to interest on trade accounts receivable and royalties received by a textbook publisher who usually printed and sold the books but on occasion would license a customer to use the publisher's plates to print the books in the customer's facilities.

The California approach was strongly recommended at the May 1957 conference and was accepted by Professor Pierce. All "business income" would be apportioned by formula, and the single-situs allocation rules would be confined to "non-business income." I furnished the language defining business income which I thought was a distillation of the California case law. The thought that I was creating a two-prong test didn't occur to me at the time, but I will say that the two-prong analysis in the subsequent cases has seemed to me to produce proper results.

Another feature of Pierce's first draft was that the default rule for single-situs allocation was to be the "principal income state," defined as the state to which the largest amount of apportionable income is assigned. For example, if the taxpayer is not taxable in the state where its patent is being used by a licensee, the royalty income would be allocated to the taxpayer's principal income state. The state conferees didn't question the rationality of this; they just thought it was too novel. They recommended that the default rule be changed to commercial domicile, a concept that was well-developed in the case law, and Pierce agreed.

I turn now to the formula structure.

Property Factor

The first multistate businesses in this country were the railroads; and around the mid-1800s, when state and local taxes were mostly *ad valorem* taxes, the common method to determine the jurisdictional tax base was to apply the ratio of the railroad property within the taxing jurisdiction to the property everywhere. In the early twentieth century, when taxes on or measured by income began to arise, it was natural to continue using property ratios as the way of dividing the income tax base. Then the Hans Rees decision of the U.S. Supreme Court inferentially required the states to use additional factors beyond property in apportioning income; but no one disputed that property should continue to play a role in the apportionment formula.

At the time of drafting UDITPA, there were two theories of just what role the property factor should play. One view was that it was to represent the influence of invested capital in the production of income. The other was that it was simply to be a measure of taxpayer presence in the state. Under the invested capital theory, property was valued in the factor at its tax basis, i.e., cost less depreciation, because the original capital investment should be reduced by the amount of capital recovered thru depreciation charges.

This tax basis rule was subject to criticism on several grounds. First, depreciation allowances in state income tax statutes varied so much that uniformity in apportionment percentages would not be achieved. Second, comparative productivity of old and new manufacturing facilities could not be reliably measured by their respective tax bases. An older

plant on the East Coast, now fully depreciated or nearly so, might be just as productive as a plant opened last year on the West Coast.

Most important, however, was that the invested capital theory and the taxpayer presence theory clashed over the inclusion of rented property in the factor. Rented property would have no place in the factor under the invested capital theory. Furthermore, rented property governs the allocation of the lessor's income, and including it also in the lessee's property factor would give the situs state double credit in the apportionment scheme. On the other hand, if the property factor is looked upon as a measure of taxpayer activity in the state, then the use of rented property is just as significant as the use of owned property.

Those states that were then including rented property were valuing it at eight times the annual rental. This presented another obstacle to continuation of the tax basis rule for owned property. It simply would not do to have rented property included at a constant figure (for the life of the lease) and owned property included at a steadily declining figure (cost less annual depreciation). The decision was to allow inclusion of rented property at eight times the annual rental and to switch the valuation of owned property to the constant figure of original cost.

Intangible property was deliberately left out of the property factor for several good reasons. To begin with, the biggest holders of intangible wealth, banks and financial corporations, were excluded from the act by Section 2. Also, the most common intangibles, such things as stocks, bonds and mortgages, represent claims to tangible property, and exclusion may

be necessary to avoid duplication. Finally, a stock certificate, note or bond is subject to arbitrary physical location, and inclusion could lead to manipulation of the property factor.

Payroll Factor

The main issue with the payroll factor was whether it should include compensation to independent contractors or be limited to employee wages. It was decided to exclude independent contractors for two reasons. One was to avoid the issue of whether representation in a state by an independent contractor created tax nexus for his principal. The other was to avoid problems of comparability between employee wages and independent contractor compensation when the latter may include expense reimbursements as well as the value of labor. Best of all, limiting the factor to employee wages made it easy to verify both the location and amounts to be included. Compensation is allocated to the state to which the unemployment insurance compensation is paid, and the amounts can be verified by looking at the employer's payroll tax returns.

It may be noted that there is no throwback rule for the payroll factor as there is for the sales factor. Payroll which these rules would allocate to a state where the employer's activities are within the protection of Public Law 86-272 would be in the denominator of the factor but not in the numerator for any state. Of course, UDITPA was adopted two years before P.L. 86-272 was enacted.

Sales Factor

Pre-UDITPA, there were three approaches to the sales factor: origin, destination, and solicitation. The origin approach was quickly dismissed as duplicative of the property and sales factors and inattentive to the contribution of markets to the production of income. The destination approach answered these objections nicely, but it created the problem of possible non-taxability in the destination state. The solicitation approach answered that problem, for there would be taxable nexus in the state where salespeople were present and acting, but it could be difficult to determine just what employee activity was responsible for the sale. The solution was to adopt the destination theory and supplement it with a throwback rule to fill the gap where the taxpayer does not have taxable nexus in the destination state. The alternative of a throwout rule did not come up.

The destination rule was not considered appropriate for sales to the federal government. The government is present to some degree in all 50 states, which means that the destination state of a particular government order of goods is not really providing the market. It also means that a destination rule could be subject to manipulation, i.e., by arranging for delivery elsewhere than in a high-tax destination state. So place of shipment was adopted as the rule for government sales.

The language used in the destination rule – "sales of tangible personal property are within this state if the property is delivered or shipped to a purchaser . . . within this state" – has given rise to the "dock sale" issue. If a purchaser located in State A picks up the goods at the taxpayer's dock in State B, is the sale to be assigned to State A or State B? This depends on

whether the words "within this state" modify the word "purchaser" or the word "delivered." The problem was not anticipated by the drafters, but it seems that the courts have uniformly held that "within this state" refers to "purchaser," and the sale should be assigned to State A, the state of consumption, rather than State B, the state of delivery.

Also unanticipated by the drafters was the possible inadequacy of the throwback rule when applied to "drop-shipment" sales, where a taxpayer fills an order from a customer by having the taxpayer's supplier ship the goods direct to the customer. If the taxpayer is not taxable in the destination state, i.e., the state where the customer is located, presumably the sale would be thrown back to the state from which the supplier shipped the goods; but if the taxpayer is also not taxable in that state, the throwback rule as stated in UDITPA will not prevent a tax gap. Some have suggested that the tax administrator could construct a double-throwback rule under UDITPA § 18 to prevent this gap.

Section 17 on the sales factor attribution of sales other than sales of tangible personal property is the weakest part of the act. Why did the drafters give such short shrift to the subject in Section 17? My impression is that they thought they had written a good act for manufacturing and mercantile businesses and that most of the non-manufacturing and mercantile businesses were not intended to be covered by the act, i.e., they would fall within the exclusion of financial organizations and public utilities as broadly defined in Section 1. Professor Pierce, in his October 1957 TAXES Magazine article, confessed that resort would often have to be made to the equitable adjustment provisions in Section 18 when dealing with service businesses.

The express rule of Section 17, allocating such sales to the state where the income producing activity occurs, does have the virtue of assuring that there will be jurisdiction to tax the income, but the "all or none" aspect of the rule has been criticized as excessively arbitrary. If the income producing activity takes place in two or more states, should the state where the greatest costs of performance are incurred receive 100 percent credit in the numerator of its sales factor?

The MTC regulation does a good job of fleshing out Section 17. It makes it clear that receipts from leases and licenses of real and tangible personal property are to be allocated to the place where the property is located and not the place where the lease or license was negotiated. It effectively converts the all-or-none rule to a pro rata rule by providing that where services are performed partly within and partly without the state, the services performed in each state will constitute a separate income producing activity, and the receipts attributable to this state shall be measured by the ratio of the time spent in performing the services in this state bears to the total time spent everywhere. I think the regulation produces sound results, but I have to wonder whether it could be subject to the charge of being legislative in nature and beyond the authority of the tax administrator.

Still not answered by either Section 17 or the MTC regulation is the sales factor attribution of income from intangible personal property such as patent and copyright royalties, interest and dividends. When the drafters inserted the business-nonbusiness income distinction into UDITPA, making such income sometimes apportionable by formula, they should have

addressed the attribution of the income in the sales factor. But again, Section 18 can be enlisted to fill the breach.

Equitable Apportionment

Before UDITPA, state corporate income tax statutes usually gave the tax administrator some discretion to depart from the standard apportionment formula to avoid unreasonable results in particular cases. UDITPA goes beyond this. In Section 18, it gives both the tax administrator and the taxpayer the opportunity to initiate variations in apportionment methods. The drafters probably thought of Section 18 as a tool to be used to avoid gross distortion under the facts of a particular taxpayer. The adopting states and the MTC, however, have chosen to use it in a much broader way. It has become the authority for devising special factors and formulas for whole industries, and this is to be applauded.

The process has been to hold conferences with industry representatives at which a consensus is sought on the structure of a formula that will meet the "fairly represent" test and incorporate this into a formal regulation which will be uniformly applied to all taxpayers in that industry; but any industry member can still petition for some other kind of variance under Section18. Overall, this procedure has been a boom to uniformity.